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The stumbling block in asset management disputes: the quantification of damage in Switzerland

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It has been said that ‘damages assessments and quantifications are going to become more sophisticated to address the increasing complexity of today’s business world’.¹ Swiss case law has followed this trend by developing complex decisions that establish requirements for the quantification of damage in various financial disputes, given that Swiss law does not provide for a specific methodology to be applied. The Swiss Supreme Court has simplified damage calculations in asset management disputes by accepting the use of a hypothetical portfolio as a benchmark of the management that should have been performed regarding the portfolio. A recent Supreme Court decision, however, unearthed old case law requiring the claimant to quantify damage by applying a methodology called ‘concrete calculation’ (in French, *calcul concret*, and in German, *konkrete Berechnung*).

As damage is often the stumbling block that leads bank clients to lose their cases, this article will outline the concept of damage under Swiss law before critically analysing Swiss case law and drawing on the lessons to be learned. Some considerations about the complexity of financial disputes, damage computation and access to justice will be expressed as a conclusion.

The concept of damage applied to asset management disputes

There is no definition of damage (ie, harm or loss) under Swiss statutory law and as such, this notion is generally defined under case law and by legal scholars as the involuntary decrease of the wealth of a person.² This refers to the so-called ‘difference theory’ (in French, *théorie de la différence*, and in German, *Differenztheorie*) according to which damage is generally understood as economic harm under Swiss law, that is, an arithmetical notion, by contrast to ‘normative damage’, that is, a value judgement of the damage. Damage thus arises in the form of a decrease of assets, increase of liabilities, absence of increase of assets or decrease of liabilities.³

The Swiss Supreme Court held that this general notion of damage must be adapted in each case, taking into account the specificities of the financial industry.⁴ The features of damage are different depending, in particular, on the nature of the contractual relationship with the bank (discretionary asset management agreement, advisory agreement, execution-only service, etc) and the type of financial products involved.

When a client enters into a discretionary asset management agreement, the client is generally entitled to positive damages. Because it is often impossible to determine what authorised transactions the asset manager would have carried out instead of unauthorised transactions, Swiss case law has established that damage may be computed by comparing portfolios.⁵ The damage thus consists of the difference between the results of: (1) the portfolio managed in breach of contractual obligations (the client's profile, investment objectives, level of risk aversion, investment restrictions, etc); and (2) a hypothetical portfolio managed during the same period but in compliance with the bank's contractual obligations.

To reconstitute the 'hypothetical portfolio', that is, the portfolio as it would have been had the damaging event not occurred, one must consider a portfolio of the same size, managed over the same period of time in accordance with the contractual obligations of the asset manager, and based on the specific knowledge of the parties and the market expectations in the relevant period of time. However, the benchmark should not be the portfolio that would have been obtained based on the management of a very successful asset manager (because such a hypothetical portfolio is made *a posteriori*), but rather the result obtained by an average and serious manager at the time the contested investments were made.

The Swiss Supreme Court decision of 10 October 2016

In the present case,⁶ a Swiss asset manager and its client entered into an asset management agreement in 1995. The client also designated the asset manager as the executor of her will. When the client passed away, the competent authority appointed the chairman of the board of directors of the asset management company as a tutor of the client's son, who was a minor at the time of her demise. Following a dispute with the chairman, the son terminated the asset management mandate in March 2004 and initiated proceedings on 19 November 2010 against the asset management company.

He alleged that the defendant had carried out unauthorised traded options. To calculate his damage, the claimant used two methods. The first consisted of a concrete calculation of the damage, listing each option transaction and the corresponding loss. The second

method compared the result of the portfolio managed in violation of the mandate with that of a hypothetical portfolio (Pictet LPP-Index 93).

The District Court held that the claimant had not been adequately informed of the risk of the options transactions, which had not been approved or ratified, and ordered the asset management company to pay damages. Because the claimant had quantified the loss using the aforementioned list, the District Court found that it was unnecessary to calculate the damage by reference to a hypothetical portfolio. This judgment was confirmed by both the Cantonal Court of Zurich and Swiss Supreme Court.

The defendant complained before the Swiss Supreme Court that the lower court had committed an error of law in the calculation of the damage by taking into account only the losses resulting from the options transactions. It also criticised the Cantonal Court of Zurich for failing to consider the result of the management of the assets as a whole. The asset management company had alleged that a comparison of the management performed to a benchmark other than the Pictet index showed that the client's portfolio had actually suffered a lower loss than would have resulted from a hypothetical portfolio. As a result, no damages could be claimed.

The Swiss Supreme Court confirmed that a comparison of the portfolio is not necessary when a concrete calculation of the damage is possible and can be demonstrated. Losses may be offset by profits duly proven by the defendant. However, the gains from the compliant portfolio management cannot be offset against losses from non-compliant transactions. In the present case, the claimant had demonstrated the actual losses resulting from the unauthorised trading of options, and the courts of Zurich had taken into account the profits proved by the asset management company related to these operations.

Lessons learnt

A hasty analysis of this judgment of the Swiss Supreme Court could cause one to wrongly believe in a change in well-established case law wherein in an asset management dispute, the damage should be calculated by comparing the result of the portfolio administered in violation of the mandate with that of a hypothetical portfolio. However, this Supreme Court's decision is, in fact,

an exception to case law. In its decision, the District Court referred to a decision of the Swiss Supreme Court of 10 November 2006,⁷ which dealt with a case in which a bank had failed to sell shares in a timely manner when the price was falling. The Swiss Supreme Court highlighted two types of contractual breaches in its judgment: (1) breach relating to the investment strategy (mismanagement of the portfolio as a whole); and (2) breach pertaining to certain individual investments (mismanagement confined to a part of the portfolio). In the first case, the damage calculation must cover the entire portfolio and the use of a hypothetical portfolio is admissible. In the second, the damage computation should be limited to the investments at issue (concrete calculation of the damage, as in the aforementioned case). The Swiss Supreme Court referred to a doctrine that favoured this distinction in terms of the extent of the management actions at issue, either between: (1) management overall or mostly not in accordance with the agreed strategy; and (2) a few investments operated in the framework of a properly managed portfolio.

That being said, there is no obligation for a claimant under Swiss law to produce an independent expert report on the damage computation. However, the claimant bears the burden of proof relating to: (1) the breach of contract; (2) damage; and (3) causation link; the bank's fault being presumed. In practice, it is strongly advisable to appoint a financial expert to work closely with the client's counsel in order to evaluate the strengths and weaknesses of the claim, including how damage arguments should be articulated in light of the facts and how the adverse party is likely to respond. In complex cases, the scope of the financial expertise may encompass the three aforementioned conditions for liability, as well as explain in lay terms the simple rationale behind financial transactions to a Swiss judge, who would generally not have a background in finance. Swiss courts are strict with the requirement of sufficiently proving damage and tend to dismiss the claim if the damage is not correctly demonstrated and articulated. A bank may therefore successfully defend itself by arguing that the methodology for damage calculation was inadequate in the case at hand and/or deficient, even where there has been a breach of contract by the bank.

Complexity and justice

Nowadays, cutting-edge technology makes it possible, in many cases, to calculate the concrete damage incurred, even when numerous non-compliant transactions were undertaken. Nevertheless, the concrete calculation listing each transaction and its corresponding gain or profit should remain the exception for several reasons. First, the Swiss Supreme Court itself held that this methodology shall be limited to cases where only a few unauthorised transactions were carried out and/or only a well-delimited part of the portfolio was mismanaged. Second, it should be stressed that the amount of damages resulting from the concrete calculation must be adjusted to market fluctuations occurring over the duration of the asset management agreement. The adjustment is made using an adequate hypothetical portfolio.⁸ For instance, if the hypothetical portfolio had a negative performance of minus ten per cent, a concrete loss of €40m will be reduced by the same negative performance and the claimant will be entitled to a compensation of €36m. It follows that even with a concrete damage calculation, a hypothetical portfolio should be used, the rationale being that if this amount had been invested in accordance with the asset management agreement, it would have benefited from the positive performance of the market or be impacted by the negative performance. Under Swiss law, the reference to a hypothetical portfolio may be considered as an application of Article 42(2) of the Swiss Code of Obligations, which allows the court to estimate the damage at its discretion in light of the normal course of events,⁹ as it is retrospectively impossible to know with certainty which authorised transactions the bank would have carried out when diligently managing the claimant's portfolio. Consequently, the concrete damage calculation encompasses (partly) the *ex aequo et bono* principle, and thus a court should not dismiss a claim too easily on the ground that the claimant did not calculate the damage by using the methodology for the concrete damage but merely used a hypothetical portfolio compared with the mismanaged portfolio. Third, requiring a concrete calculation of the damage would trigger higher costs to be advanced by the claimant and restrain access to justice as the latter is only entitled to compensation for his/her expert costs if he/she prevails. To concretely

calculate the damage, all operations shall be matched, which requires the bank to remit all operation advice notes, tickets, confirmations and other relevant documents reporting the details of the operations. Finally, the application of the concrete calculation can prove extremely complex if it involves more sophisticated investments than tradable shares or options, such as exotic options or structured products. Indeed, these products are not necessarily listed and liquid. They may also provide for dozens of fixing or settlement dates, and the bank documentation surrendered to a customer does not always allow for the reconciliation of operations. The concrete calculation should therefore remain an exception in asset management disputes. It is worth noting that for disputes relating to other contractual relationships, punctual advisory agreements and execution-only services, the concrete calculation is the rule. When a general advisory agreement is reached (the bank advises the client on all or part of his/her assets and regularly advises him/her on transactions according to his/her risk profile and objectives) the Supreme Court has also accepted the reference to a hypothetical portfolio as a way of calculating the damage.

In conclusion, the approach of Swiss courts to the thorny issue of quantification of damage is pragmatic. It strikes a balance between the level of proof that must be met to allocate fair compensation to a client suffering a loss and the legal protection that a bank is entitled to so that courts do not render arbitrary decisions against them. The Financial Services Act, which will enter

into force in 2018 at the earliest, has not retained the proposal of setting up a fund to contribute to the trial costs for retail clients when the disputed value is below 1m Swiss francs and he/she is not particularly wealthy. The concept of damage computation by a comparison of portfolios therefore plays an important role so as not to further restrain access to justice by requesting costly financial expertise to prove the concrete loss suffered. As Aristotle said: 'The virtue of justice consists in moderation, as regulated by wisdom'. One can thus consider the above concept as a means to make particular justice fit general justice.

Notes

- 1 Interview with Gregory K Bell (June 2012) www.financierworldwide.com/quantification-of-damages-in-commercial-disputes/#.WS69kcJMSUk accessed on 31 May 2017.
- 2 ATF 116 II 441 of 19 June 1990.
- 3 ATF 127 III 543 of 14 June 2001, JdT 2002 I 217.
- 4 Decision of the Swiss Supreme Court of 10 November 2006, 4C.158/2006.
- 5 See, eg, decision of the Swiss Supreme Court of 15 January 2008, 4A_351/2007.
- 6 Decision of the Swiss Supreme Court of 10 November 2006, 4C.158/2006.
- 7 *Ibid.*
- 8 *Ibid.* Note that in the decision of the Swiss Supreme Court of 10 October 2016, 4A_280/2016, no hypothetical portfolio was referred to. In our understanding, this is due to the fact that the bank failed to put forward that the concrete damage should have been reduced by the negative performance of an adequate hypothetical portfolio.
- 9 Article 42(2) of the Swiss Code of Obligations provides: 'Where the exact value of the loss or damage cannot be quantified, the court shall estimate the value at its discretion in light of the normal course of events and the steps taken by the injured party'.